No. 78- 606

IN THE

Supreme Court of the United States

October Term, 1978

The Pacific Telephone and Telegraph Company,
Petitioner,

v.

The Public Utilities Commission of the State of California, and Robert Batinovich, Vernon L. Sturgeon, Richard D. Gravelle, Claire T. Dedrick, and William Symons, Jr., the members of said Public Utilities Commission, et al.,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF CALIFORNIA

Robert V. R. Dalenberg
Margaret deB. Brown
140 New Montgomery St.
San Francisco, Cal. 94105
(415) 542-1507

Attorneys for The Pacific Telephone and Telegraph Company

Of Counsel:

Mortimer M. Caplin
1101 Seventeenth St., N.W.
Washington, D.C. 20036
(202) 862-5050

Frank Rothman
Gary N. Jacobs
2049 Century Park East
Los Angeles, Cal. 90067
(213) 556-8000

October 1978

INDEX

CITATIONS

CASES:

CONSTITUTION, STATUTES AND REGULATIONS:

CONSTITUTION:

IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

No. 78-

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY,
Petitioner,

v.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF OF CALIFORNIA, ET AL.,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF CALIFORNIA

Petitioner, The Pacific Telephone and Telegraph Company, respectfully prays that a writ of certiorari issue to review the judgment of the Supreme Court of California entered on July 13, 1978, upholding the decision of the California Public Utilities Commission entered on September 13, 1977.

OPINIONS BELOW

The final judgment of the California Supreme Court (App. A, p. 1A) is reported at 21 Cal. 3d, Official Advance Sheets, No. 21, minutes, p. 3 (1978). The judg-

ment was entered without opinion, one judge dissenting from the Court's refusal to issue a writ of review. The decision of the California Public Utilities Commission (App. B, pp. 3A-74A) is as yet unreported.

JURISDICTION

The judgment of the California Supreme Court was entered July 13, 1978. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(3).

QUESTIONS PRESENTED

1. Did the California Public Utilities Commission violate the provisions of the Internal Revenue Code §§ 46(f) and 167(*l*), and therefore the Supremacy Clause of Article VI of the United States Constitution, by requiring petitioner to pass on to its customers federal tax benefits of accelerated depreciation and investment tax credits, when petitioner is forbidden by federal law to receive such tax benefits if it passes them on rather than having them available, as Congress contemplated, for capital investment?

2. Did the California Public Utilities Commission deprive petitioner of its property without due process of law in violation of the Fourteenth Amendment: (a) by reducing rates on the basis of outdated financial estimates when actual data more favorable to petitioner were before the Commission, in violation of this Court's ruling in *West Ohio Gas Co.* v. *Public Utilities Commission*, 294 U.S. 79 (1935); (b) by making rates on the assumption that petitioner was eligible for accelerated depreciation and the investment tax credit, when the Commission's ratemaking methods themselves destroyed that eligibility?

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Article VI and the Fourteenth Amendment to the Constitution; pertinent provisions of the Internal Revenue Code of 1954, 26 U.S.C. §§ 46(f), 167(a), 167(*l*), 167(m); and the Treasury Regulations thereunder, 26 C.F.R. §§ 1.167(*l*)-1(a)(1),-1(h)(1), (6), are reprinted in Appendix C, pp. 75A-93A.

STATEMENT

This case arises from a conflict between federal tax policy as enacted into law by Congress in 1969, 1971 and 1975, when it set conditions on the use of accelerated depreciation and the investment credit by regulated public utilities, and state ratemaking policy regarding those federal tax benefits, as ordered by the California Public Utilities Commission ("Commission") and the California Supreme Court.

Petitioner, The Pacific Telephone and Telegraph Company ("Pacific"), is a California corporation engaged in the business of rendering telephone service in the State of California. As such, its intrastate rates and services are subject to regulation by the Commission, pursuant to the California Public Utilities Code.

Under the Internal Revenue Code, Pacific cannot be eligible for the tax benefits of accelerated depreciation and the investment credit unless its rates are

established in a manner consistent with ratemaking standards prescribed under §§ 167(*l*) and 46(f).

The decision of the Commission, as upheld by the California Supreme Court, reduced Pacific's intrastate telephone rates by adopting new ratemaking methods with respect to these federal tax benefits.[1] California's ratemaking methods misinterpret the requirements for eligibility for those tax benefits. After studying the Commission's decision, the Internal Revenue Service has issued formal rulings that these tax benefits will not be available to Pacific if the Commission's decision is placed in effect. Thus, if the Commission's order becomes final, Pacific will face a federal tax liability in excess of one billion dollars.

A. Legislative Background

Congress first allowed the use of accelerated methods of depreciation for federal income tax purposes in 1954, when it enacted § 167(b) of the Internal Revenue Code. The effect of accelerated depreciation, as contrasted with straight-line depreciation, is to produce higher deductions and lower income taxes in the early years of an asset's life, and to produce lower deductions and, consequently, higher income taxes in later years. Accelerated depreciation thus acts to defer federal taxes from early years to later years, leaving

[1] The Commission decision also applies to General Telephone Company of California ("General"). General also intends to petition this Court for certiorari. General and Pacific have filed a separately bound Joint Appendix, referred to herein as "App."

funds with the taxpayer available for investment during the intervening period. This is what Congress intended: "The faster tax writeoff would increase available working capital and materially aid growing businesses in the financing of their expansion." H.R. Rep. No. 83-1337, 83d Cong., 2d Sess. 24 (1954).

As originally enacted, the 1954 Code contained no special provisions relating to the treatment of accelerated depreciation for regulated utilities. In the absence of explicit federal limitations on regulatory agencies, the stated Congressional intent of stimulating the economy by fostering capital formation was partially thwarted in ensuing years. Since federal income tax expense represents an element of cost of service for ratemaking purposes, some regulatory agencies treated the tax deferral resulting from accelerated depreciation as a reduction in cost of service, and therefore lowered rates. In this way, the agencies immediately passed through to customers the amount of the current tax deferral. This practice, known as "flow-through" ratemaking, prevented the accumulation and investment of capital that Congress had intended when it enacted the 1954 Code. By reducing the utility's income the practice also reduced the amount of federal taxes to be paid.

In response to what Congress saw as an undesirable trend toward flow-through ratemaking, § 167 was amended as part of the Tax Reform Act of 1969.[2]

[2] Tax Reform Act of 1969, Pub. L. No. 91-172, § 441(a), 83 Stat. 625 (1969). *See Federal Power Comm'n* v. *Memphis Light, Gas*

Under newly-enacted § 167(*l*), a utility such as Pacific which had not previously used accelerated depreciation for federal tax purposes could thereafter use accelerated depreciation *only* (1) if the utility used the "normalization" method of accounting in its books of account *and* (2) if the regulatory agency used the normalization method in setting rates.[3]

Under normalization as prescribed by the Code and Regulations, (1) a utility's tax expense for ratemaking purposes must be computed as though "normal" (*i.e.*, straight-line) depreciation were being used for tax purposes; (2) the full amount of the deferred taxes (*i.e.*, the difference between tax expense computed first using accelerated and then using straight-line depreciation) must be reflected in a reserve and thus be available for capital investment; and (3) the regulatory agency may not exclude from rate base an amount greater than the amount of the reserve for the period used in determining the tax expense as part of cost of service.[4]

---

and Water Div., 411 U.S. 458, 461 (1973); H.R. Rep. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. 131-134 (1969); S. Rep. No. 91-552, 91st Cong., 1st Sess. 171-176 (1969).

[3] Normalization accounting for deferred taxes is required for the financial reports of non-regulated businesses under generally accepted accounting principles. A.P.B. Opinion No. 11 (December 1967).

[4] I.R.C. § 167(*l*)(3)(G); Treas. Reg. § 1.167(*l*)-1(h)(1), (6) (App. C, pp. 82A, 86A, 88A). Essentially, the same normalization requirements govern Pacific's eligibility to depreciate its property using shorter lives under the asset depreciation range system and the class life system. *See* I.R.C. § 167(m); Treas. Reg. §§ 1.167(a)-

By allowing utilities such as Pacific to use accelerated depreciation only if normalization were followed, Congress had two principal objectives: First, to assure that the deferred taxes derived from accelerated depreciation would be available to the utilities as investment capital, and second, to avoid the additional loss of federal tax revenues that results when flow-through ratemaking is imposed.[5]

Two years after enacting § 167(*l*), Congress adopted a new investment tax credit, also designed to provide capital to stimulate modernization and expansion.[6] The investment credit is a direct dollar-for-dollar offset against taxes. It is earned in the year certain types of depreciable property are first placed in service. As with accelerated depreciation, Congress made the availability of the credit to public utilities such as Pacific conditional on strict adherence by regulatory agencies to ratemaking standards prescribed in the Internal

---

11(b)(6), 1.167(a)-12(a)(4)(iii). For purposes of this petition, reference to accelerated depreciation includes these other depreciation systems as well.

[5] The federal government's tax revenue loss from flow-through ratemaking results first, from the utilities' use of accelerated depreciation itself, and second, from the reduction in the utilities' taxable income because of lower revenues under flow-through ratemaking. It was the revenue loss attributable to the latter factor that Congress found unacceptable. *See* H.R. Rep. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. 132 (1969).

[6] Revenue Act of 1971, Pub. L. 92-178, § 105(e), 85 Stat. 503. *See* H.R. Rep. No. 92-533, 92d Cong., 1st Sess. 23-26 (1971). The 1971 Act established a 4 percent investment credit for public utility property used to furnish telephone service; the level of the credit was changed to 10 percent as part of the Tax Reduction Act of 1975, Pub. L. No. 94-12, § 301(a), 89 Stat. 26.

Revenue Code. By enacting what is now § 46(f),[7] Congress intended to achieve a result "essentially similar" to the normalization rules relating to accelerated depreciation.[8]

B. Proceedings Below

Pacific did not use accelerated depreciation in computing its federal income tax until after the passage of the Tax Reform Act of 1969 and thus can be eligible only if its rates are made using normalization. In 1970, the Commission held it would thereafter set Pacific's rates under normalization, stating that "it would now be futile to consider the relative merits of flow-through and normalization" *Re Pacific Tel. & Tel. Co.*, 71 Cal. P.U.C. 590, 594 (1970). The Supreme Court of California, however, annulled this order, suggesting that the Commission invent a "fictitious factor" and thereby "strike a balance between [the] two extremes" of flow-through and normalization. *City and County of San Francisco* v. *Public Utilities Commission*, 6 Cal. 3d 119, 130, 490 P.2d 798, 804 (1971).

In 1973, a new rate proceeding was initiated and in 1974 the Commission granted a rate increase. The Commission again concluded that only strict adherence to the ratemaking requirements of the Internal Revenue Code would preserve eligibility for the federal tax

[7] This provision was originally enacted as § 46(e) in 1971, but was redesignated as § 46(f) under the Tax Reduction Act of 1975.

[8] H.R. Rep. No. 92-533, 92d Cong. 1st Sess. 25 (1971); S. Rep. No. 92-437, 92d Cong., 1st Sess. 38 (1971).

benefits, and that loss of eligibility "would be a financial disaster to Pacific and would cause a substantial deterioration of service within a few years." *Re Pacific Tel. & Tel. Co.*, 77 Cal. P.U.C. 117, 161 (1974). This decision was appealed by intervenors advocating flow-through ratemaking. The California Supreme Court affirmed, except as to the federal tax issue. It found that the Commission had not understood the full scope of its powers. It therefore remanded the tax aspect of the case so that the Commission could consider the tax issues with full knowledge of its authority. *City of Los Angeles* v. *Public Utilities Commission*, 15 Cal. 3d 680, 708, 542 P.2d 1371, 1390 (1975). The proceeding below followed. It was expressly limited to a determination of the ratemaking methods the Commission would apply to accelerated depreciation and the investment tax credit.

In the proceeding below, the Commission once again held it to be in the public interest that petitioner's eligibility for these tax benefits be preserved and found that loss of eligibility would create "staggering" problems (App. B, p. 22A). Nevertheless, a divided Commission adopted two new ratemaking methods which departed from the prior interpretations of federal requirements that were known to preserve eligibility. For accelerated depreciation, the Commission adopted a ratemaking method called "averaged annual adjustment" ("AAA"), and for the investment credit, the Commission adopted a method called "annual adjust-

ment" ("2A").[9] The Commission held that these ratemaking methods

> ". . . maintain the eligibility of the utilities to use accelerated depreciation and ITC and comply with the requirements of the Internal Revenue Code relating to Pacific and General." (App. B, pp. 49A-50A.)

Applying these ratemaking methods (together with imputed accelerated depreciation with flow-through for property acquired in 1968 and 1969), the Commission ordered Pacific to make rate refunds for past periods totaling $206,000,000 (through January 1, 1977) and to reduce present rates by an amount in excess of $60,000,000 per year.[10] Thus the order effected a substantial flow-through of the tax benefits. The $60,000,000 on-going rate reduction, for example, represents flow-through of approximately $55,000,000 per year over prior normalization methods. Nevertheless, the Commission majority rejected Pacific's contentions that the new ratemaking methods were plainly inconsistent with the eligibility requirements under the Internal Revenue Code and would therefore deprive Pacific of the

[9] These ratemaking methods are described at pp. 15-21, *infra*.

[10] Because of the protracted period over which the tax issues were considered, the Commission's decision adjusted rates established in three separate rate proceedings. The Commission granted rate increases in 1974 and 1976. Those rates were subject to refund pending the resolution of this proceeding. A third rate case was pending when the Commission issued its order in this proceeding and the tax issues in that case were covered by the order in the present case.

very tax benefits it was ordered to pass on to its customers.[11] The Commission also rejected a recommendation by the Administrative Law Judge in his proposed report that a 180-day period be allowed before the order was placed in effect so rulings from the Internal Revenue Service could be obtained.[12]

Pacific proceeded promptly to submit ruling applications to the Internal Revenue Service to determine eligibility. Pacific requested the Commission to participate before the Internal Revenue Service so that its position would be fully stated, but the Commission (two members dissenting) refused.[13]

On June 8 and July 27, 1978, the Internal Revenue Service issued rulings that, if the Commission's decision is placed in effect, Pacific will forfeit its eligibility for both accelerated depreciation (App. D, pp. 95A-115A) and the investment credit (App. E, pp. 133A-142A). Immediately after the issuance of the first ruling, Pacific requested the Commission to reconsider its decision in light of the position of the Internal Revenue Service. The Commission refused.[14]

Pacific had petitioned the California Supreme Court for review before the Internal Revenue Service rulings

[11] *E.g.*, Ex. 7; Post-hearing Brief, pp. 5-47; Application for Rehearing, pp. 10-21. Pacific also raised below the Constitutional arguments here asserted. E.g., Ex. 7, pp. 24-25; Prehearing Memorandum on Refund Plans, pp. 4-7; Post-hearing brief, pp. 48-74; Application for Rehearing, pp. 17-28.

[12] Proposed Report, January 19, 1977, pp. 38-39, 42.

[13] Cal. P.U.C., Decision No. 88215 (December 6, 1977).

[14] Cal. P.U.C., Decision No. 88972 (June 14, 1978).

were issued.[15] The California Supreme Court denied Pacific's petition for review on July 13, 1978.[16] Under California law, the California Supreme Court's action constitutes an affirmance on the merits.[17] The Commission has granted a stay of its decision while review is being sought in this Court.

REASONS FOR GRANTING THE WRIT

I

The California Decision Is Directly At Odds With The Plain Meaning And Purpose Of The Federal Tax Laws, With The Treasury Regulations Implementing Those Laws, With The Position Of The Internal Revenue Service And, Therefore, With The Supremacy Clause Of Article VI

In the area of federal taxation, as in other areas of primary federal competence, the States are obliged by the Constitution to abide by national law. *Art. VI of*

[15] Pacific urged that the Commission's decision conflicted with the eligibility requirements provided under the Internal Revenue Code, conflicted with Article VI of the United States Constitution, and denied due process in violation of the Fourteenth Amendment. Petition for Writ of Review in the California Supreme Court, pp. 5-6, 11-71; Reply Brief of Pacific in the California Supreme Court, pp. 4-33.

[16] Pacific had informed the California Supreme Court that rulings were being sought from the IRS and requested, *inter alia*, that the Court defer its decision until after the rulings were issued. The IRS ruling on accelerated depreciation, which was issued on June 8, 1978, was submitted to the California Supreme Court on June 9, 1978. The IRS ruling relating to the investment credit was issued on July 27, 1978, after the California Supreme Court denied review.

[17] *People* v. *Western Air Lines, Inc.*, 42 Cal. 2d 621, 630, 268 P.2d 723, 728, *appeal dismissed*, 348 U.S. 859 (1954).

the Constitution. In this instance, California has misinterpreted federal statutes thereby frustrating the basic Congressional purposes. Intervention by this Court is necessary to preserve federal policy and to ensure compliance with federal standards by California and other States when they interpret the same law.

The federal laws involved here do not compel a state commission to authorize a public utility to take accelerated depreciation or investment credit. The federal laws do, however, impose conditions on eligibility. If eligibility is to be preserved, the commission must allow the utility to retain a specified portion of the current tax deferrals or savings for investment purposes and must not deplete the tax benefits by reductions of the utility's rates.[18] The purpose of the federal laws was to assist the economy by stimulating investment while maintaining the level of federal tax collections,[19]

[18] In *Memphis Light, Gas & Water Div.* v. *Federal Power Comm'n*, 462 F.2d 853, 856-60 (D.C. Cir.), *cert. denied on this issue*, 409 U.S. 941 (1972), the Court of Appeals for the District of Columbia Circuit ruled, in a related context, that the Tax Reform Act of 1969 deprived a regulatory agency of the power to set a utility's rates by imputing accelerated depreciation with flow-through. Relying on clear statements of congressional purpose, the Court held that unless the regulatory agency was willing to place the utility on straight-line depreciation for tax purposes and set rates accordingly, it was required to follow the normalization treatment of accelerated depreciation for ratemaking purposes.

[19] *See, e.g.*, S. Rep. No. 92-437, 92d Cong., 1st Sess. 35-41 (1971); S. Rep. No. 91-552, 91st Cong., 1st Sess. 171 (1969); H.R. Rep. No. 83-1337, 83d Cong., 2d Sess. 24 (1954).

and not to provide short-run reductions in consumer costs.[20]

Starting in 1970, the Commission assured Pacific that it would be eligible for accelerated depreciation.[21] Pacific has filed its tax returns claiming the benefits and now finds its eligibility retroactively jeopardized at least back to 1974. The Commission has claimed to satisfy the federal conditions in determining Pacific's rates. Having made this undertaking to comply with federal law, the Commission—and the California Supreme Court adopting its decision—are bound by the terms of that law. The Supremacy Clause demands no less. "[A] State is without power by reason of the Supremacy Clause to provide the conditions on which the Federal Government will effectuate its policies. Whether the federal policy is a wise one is for the Congress and the Chief Executive to determine." *United States* v. *Georgia Public Service Commission,* 371 U.S. 285, 293 (1963).

A decision such as the Commission's in this case reduces current federal tax collections contrary to Congressional policy, and the economic stimulation resulting from the capital formation Congress sought is

[20] If rates are maintained under normalization, in the long run they will be lower than under flow-through accounting. Tr. 889; 1973 Tr. 573-574, 647-648, 2157; Ex. 27.

[21] Decision No. 77984, 71 Cal. P.U.C. 590 (1970), *reversed, City and County of San Francisco* v. *Public Utils. Comm'n,* 6 Cal. 3d 119, 490 P.2d 798 (1971); Decision No. 83162, 77 Cal. P.U.C. 117 (1974), *reversed in part, City of Los Angeles* v. *Public Utils. Comm'n,* 15 Cal. 3d 680, 542 P.2d 1371 (1975).

frustrated, first by the impact of the partial flow-through of the tax benefits and ultimately by ineligibility. The effect of lost eligibility is the imputation of the tax benefits for ratemaking with partial flow-through since 1974.[22] These results create a serious "obstacle to the accomplishment and execution of the full purposes and objectives of Congress." *Hines* v. *Davidowitz,* 312 U.S. 52, 67 (1941).[23]

A. Accelerated Depeciation.

Pacific can only be eligible to use accelerated methods of depreciation for federal tax purposes if its rates are made using normalization. To explain how the California AAA method destroys that eligibility it is necessary to understand normalization ratemaking.

The utility's rates are set to permit it sufficient revenue to cover (a) its itemized expenses, plus (b) a rea-

[22] While we focus primarily on the AAA and 2A, the decision also directly imposed rate reductions based upon imputed accelerated depreciation with flow-through as to certain pre-1970 property, even though Pacific was entitled to straight line depreciation for such property by § 167(*l*)(1). *See Federal Power Comm'n* v. *Memphis Light, Gas & Water Div.,* 411 U.S. 458, 467 (1973), where this Court stated: "a utility using straight-line depreciation with respect to its pre-1970 property could not switch to accelerated depreciation, nor could a utility be required to switch to flow-through with respect to pre-1970 property." This alone created $43.5 million in refunds and a $5.5 million ongoing rate reduction (App. B, pp. 31A-32A).

[23] *See* S. Rep. No. 91-552, *supra* at 173-174; Staff of Joint Comm. on Internal Revenue Taxation, 91st Cong., 2d Sess., General Explanation of the Tax Reform Act of 1969 at 152 (Comm. Print 1970); *cf. Memphis Light, Gas & Water Div.* v. *Federal Power Comm'n,* 462 F.2d 853 (D.C. Cir. 1972), *cert. denied on this issue,* 409 U.S. 941 (1972).

sonable return on investment (*i.e.,* the rate of return times the rate base). Federal income tax is one of the itemized expenses. To meet the normalization requirements, federal tax expense is computed using straight-line depreciation. Then, to determine the taxes deferred, that same tax expense is recomputed using accelerated depreciation. The difference between the two tax computations is the amount of taxes deferred that year and this amount is placed in a reserve for deferred taxes.[24]

The normalization rules provide that the balance in the reserve for deferred taxes may be used to reduce the rate base.[25] Thus the current period's deferred taxes appear first, as part of the itemized tax expense and second, as the most recent addition to the balance in the reserve which is used to reduce rate base. To keep this synchronized and prevent flow-through, the Regulations limit the deduction from rate base to "the reserve for deferred taxes for the period used in determining the tax expense in computing cost of service".[26]

[24] I.R.C. § 167(*l*)(3)(G); Treas. Reg. § 1.167(*l*)-1(h)(1), (2).

[25] Treas. Reg. §§ 1.167(*l*)-1(a), 1.167(*l*)-1(h)(6). Congress delegated special authority for the Secretary to promulgate regulations to carry out the "purposes" of Section 167(*l*). I.R.C. § 167(*l*)(5). This delegation is in addition to the Secretary's general authority to issue interpretive regulations. I.R.C. § 7805.

[26] Treas. Reg. § 1.167(*l*)-1(h)(6). If the exclusion from the rate base is so limited, the resulting decrease in revenues merely prevents the utility from earning a return on the portion of its operating assets financed with deferred taxes. If an excessive amount is excluded from the rate base through overstating the deferred tax reserve, however, the effect is to flow through a portion of the deferred taxes, thereby defeating normalization.

A part of the ratemaking process which is unrelated to the computation of either the itemized tax expense or deferred tax reserve but which is relevant to understanding the Commission's decision is the "gross up" process. If, for example, the revenue from existing rates covers only the itemized expenses, then multiplying the rate of return times the rate base would give the amount of *net* revenue increase needed to achieve the authorized return. To compute the gross revenue needed to achieve that net revenue, the procedure in California has been to multiply the net revenue needed by a "net-to-gross multiplier". This multiplier has components to account for the effects of uncollectables and state and federal taxes.[27]

The California AAA reduced the rate base for the test year by the average of the deferred tax reserve for the test year plus the succeeding three years.[28] The reserve balances in each succeeding year increased, so that the four-year average far exceeded the reserve for the test year. This violated Treas. Reg. § 1.167(*l*)-1(h)(6). Indeed, Example (1) in that Regulation explicitly shows the California AAA method to be inconsistent with the normalization requirements.[29]

[27] *See* Table 1 to the decision, notes 5 and 6 (App. B, pp. 56A-57A).

[28] The decision does not state why it chose a four-year period. Had it elected to use a longer period for the average it would accomplish 100% flow-through.

[29] Treas. Reg. § 1.167(*l*)-1(h)(6)(iv), Example 1. In that example, rate base, tax expense and cost of service are determined for a single test year, as is true under AAA. The example holds that,

The Commission asserts that it has met the requirements of the Regulations by also computing tax expense in the cost of service for the same four-year period (App. B, p. 27A). But this it has not done. Its computations are set out in Table 1 of the decision (App. B, pp. 56A-57A) and show the Commission merely computed the net revenue reduction associated with the larger deduction from rate base and then converted that to a gross revenue reduction by applying the net-to-gross multiplier. It did not compute the itemized tax expense for the three later years.

Thus the AAA fails. The itemized tax expense for the three years after the test year is ignored, and the additional deferred taxes included in the four-year average reserve have not been included in the itemized tax expense for the test year. Thus, the reserve balance used does not relate to the "period used in determining . . . tax expense in computing cost of service." The net-to-gross multiplier does not enter into the computation of the tax deferral and its use cannot form a basis for eligibility. Indeed if the gross up process is all that is needed to preserve eligibility, every method of excessively reducing rate base would pass muster and the statute and regulations would be a dead letter.

---

if the amount of deferred taxes excluded from rate base exceeds the balance in the deferred tax reserve at the end of the test year, as is true under AAA, the utility is not following the normalization method of accounting (App. C, p. 89A).

B. Investment Credit.

It is equally clear that the Commission's 2A method will result in loss of eligibility for the investment credit. Section 46(f)(2) of the Internal Revenue Code places precise limits on the amount of the credit which may be flowed through to consumers. Under that section, eligibility for the credit can be maintained only if the credit is flowed through as a reduction in cost of service no more rapidly than ratably over the period for which depreciation expense is recognized on the property that produced the credit. In addition, to assure that there is not excessive flow-through, section 46(f)(2) provides that the rate base may not be reduced by reason of any portion of the credit.

The 2A method automatically reduces rates at the beginning of each year after the test year. For each year after the test year, the method reduces Pacific's test-year cost of service by a ratable portion of the estimated amount of investment credit to be received for the subsequent year. However, the method freezes Pacific's depreciation expense and rate base (as well as other figures) at test-year levels, notwithstanding Pacific's growth in each year after the test year. Thus, each annual reduction in cost of service exceeds the limits of section 46(f)(2) because cost of service is reduced not only by a ratable portion of the new investment credit but also by exclusion of the additional depreciation expense on the property which produced that credit. Moreover, in each year that 2A applies, there is an impermissible reduction in rate base, because

the additional investment which produced the credit is entirely excluded from the rate base.[30]

Although the Commission's decision professes to preserve eligibility for the federal tax benefits, the Commission openly admits that its ratemaking methods are a compromise between established normalization principles and full flow-through (App. B, p. 27A, citing 6 Cal. 3d 119, 130-31 [490 P.2d 798, 804]). But the specific ratemaking standards prescribed by the Internal Revenue Code do not permit any compromise. Nor can it be said that the Commission has narrowly missed preserving eligibility; its misinterpretation of the federal standards is egregious. Under the California interpretation, $55 million of the tax benefits are ordered to be flowed through each year, contrary to Congressional policy and the Code provisions.

In sum, the Commission has based its decision on an erroneous application of federal laws and the decision itself will have direct and far-reaching effects under those laws. The frustration of federal policy and irreparable harm flowing from this error can be prevented only by a decision of this Court and a remand of the case so that rates may be set in conformance with the eligibility requirements of the federal laws.

[30] For example, assume that in a year following a test year Pacific acquired property for $100,000,000, with a useful life of 20 years, producing an investment credit of $10,000,000 and additional annual depreciation expense of $5,000,000. Under 2A, cost of service for the year of acquisition would be reduced not only by $500,000 ($10,000,000 ÷ 20) by reason of ratable amortization of the investment credit, but also by the exclusion from cost of service of the additional depreciation expense of $5,000,000. Moreover, no portion of the $100,000,000 investment in property which produced the credit would be included in the rate base.

II

The Case Presents Important Issues As To The Proper Relationship Between The Federal Tax Laws And State Regulatory Policy. If The California Decision Is Left Standing, Federal Policy Will Be Frustrated And The Consequences To The Petitioner, To Other Public Utilities, And To Consumers Throughout The Country Will Be Devastating And Irreparable

Even when viewed in its narrowest perspective, the effect on Pacific and its ratepayers, this case is of unusual importance. Pacific faces what is probably the largest back tax liability in history. If the Commission's rates are placed into effect and Pacific's eligibility under §§ 46(f) and 167(*l*) of the Code is destroyed, Pacific will owe federal taxes, excluding interest, of at least one billion dollars.[31]

[31] The accelerated depreciation tax deferrals and the tax credits attributable to the intrastate portion of Pacific's business are:

	Reserve for Deferred Taxes	Investment Tax Credit	Annual Total
1974	$ 91,017,000	$ 24,901,000	$115,918,000
1975	108,494,000	62,157,000	170,651,000
1976	117,880,000	75,014,000	192,894,000
1977	129,800,000	88,200,000	218,000,000
1978 (est.)	141,800,000	93,800,000	235,600,000
1979 (est.)	139,900,000	113,100,000	253,000,000
Total	$728,891,000	$457,172,000	$1,186,063,000

The combined total, exclusive of interest, is the amount of the tax deficiency if the decision below is inconsistent with eligibility. (Figures are from Ex. 10A through 1976; the actual figure recorded is shown for 1977; 1978-1979 figures are estimated.)

The effect on Pacific and the people that depend upon its service will be devastating. The amounts attributable to the accelerated depreciation tax deferral and the investment credits have been invested in plant and equipment, as Congress intended, and are not available to pay the back tax liability. The uncontradicted evidence below established that borrowing enough money to finance that liability, Pacific's only alternative, would exhaust Pacific's ability to borrow (Ex. 9, pp. 26-32). The ability to sell common equity has already been impaired, for Pacific's stock sells at only about two-thirds of book value.[32] No common equity has been sold since 1973. Standard and Poor's rating of Pacific's debt securities has fallen precipitously since 1973, resulting in dramatically increased cost of debt and limiting Pacific's ability to sustain its capital investment program.

In examining the consequences if Pacific's eligibility were destroyed, the uncontradicted evidence established that Pacific would then be unable to meet the demand for telephone service (Ex. 9, pp. 31-32; Ex. 11, pp. 4-18); many orders for new or changed service could not be met and within a year 275,000 customers would be waiting for service (Ex. 11, pp. 11-12); existing facilities would be clogged and many local and long distance calls would be delayed or go uncompleted (Ex. 9, pp. 26-34; Ex. 11); and Pacific would be forced to lay off at least 12,500 employees, creating a ripple effect causing layoffs by suppliers (Ex. 11, p. 10). The destructive effect on telephone service would unquestionably injure the entire California economy.

[32] At the time of trial book value was $20.36 per share [it is now over $22.00]. The stock is traded on the New York and Pacific Exchanges. Ex. 9, p. 14.

The Commission understood this and quite correctly found that loss of eligibility would "not only create service problems . . . but would create staggering financial problems." This would ultimately result in "staggering rate increases" (App. B, p. 22A). Indeed, an appreciation of the problems led two of the three majority Commissioners to state, in a separate concurrence, that "the *ultimate* verdict on the validity of this decision will have to be made in the United States Supreme Court and the sooner that is accomplished the better off all participants will be" (App. B, p. 70A).

Petitioner is caught in the middle. The State of California holds that its action preserves eligibility under the federal tax statutes; the federal agency charged with administering those statutes has ruled that it does not. Eligibility is not within petitioner's control, for it is dependent upon the manner in which the Commission sets the rates.

If the decision below becomes final and the rates which it mandates are placed into effect, the situation will be irreversible. The Commission does not appear to have the authority to correct its ratemaking retroactively even if that were permitted under the Code.[33]

[33] *See City of Los Angeles* v. *Public Utils. Comm'n*, 15 Cal. 3d 680, 705-707, 542 P.2d 1371, 1388-1389 (1975); *Pacific Tel. & Tel. Co.* v. *Public Utils. Comm'n*, 62 Cal. 2d 634, 401 P.2d 353 (1965); I.R.C. § 46(f)(4); Treas. Reg. § 1.167(*l*)-1(h)(4).

The Internal Revenue Service audit process lags several years behind the filing of the tax returns. Pacific's returns for 1974 and later years have not, as yet, been audited. If the decision below becomes final, the Internal Revenue Service will pursue the audit process that will ultimately lead to assertion of the tax deficiencies. By the time that process is concluded and, as Pacific believes will be the case, eligibility is determined to have been destroyed, there will be no means of undoing the harm and by then the tax liability will have grown to two billion dollars.

The potential impact of the present case reaches far beyond the parties involved. Other utilities in California are already being subjected to orders with similar effect,[34] and other state ratemaking agencies are following the present proceedings closely, for some have only reluctantly met the eligibility conditions set by Congress for accelerated depreciation and the investment credit.[35] Since the effect of the decision below is to reduce rates in the short run, regulatory agencies throughout the country will find themselves under pressure to take similar actions if the Commission's

---

[34] *E.g.*, *Sierra Pacific Power Co.*, Decision No. 88337 (Cal. P.U.C. January 17, 1978).

[35] *See, e.g.*, *Re South Central Bell Tel. Co.*, 15 P.U.R. 4th 87, 117-119 (La. Pub. Serv. Comm'n 1976), *remanded on other grounds*, 352 So. 2d 964 (La. Sup. Ct. 1977); *Re Michigan Bell Tel. Co.*, 3 P.U.R. 4th 1, 15 (Mich. Pub. Serv. Comm'n 1973). At the time the Tax Reform Act of 1969 was adopted about half the regulatory agencies required flow-through accounting. *See* S. Rep. No. 91-552, 91st Cong., 1st Sess. 171-172.

decision is left standing. Not only would such actions seriously erode federal policy, but they would occasion unnecessary and grave jeopardy to utilities and give rise to a period of widespread financial uncertainty and consuming litigation. Ultimately, the effects would be borne by consumers throughout the country. Unless this Court resolves the issues presented now, while there is still time to do so effectively, the program Congress established as an aid to investment by utilities and thus as an aid to the economy will become a vehicle of destruction.

III

The Judgment Below Conflicts With The Decision Of This Court In *West Ohio Gas Co. v. Public Utilities Commission*, 294 U.S. 79 (1935), Is Destructive Of Petitioner's Financial Integrity And Deprives Petitioner Of Its Property Without Due Process Of Law In Violation Of The Fourteenth Amendment

It is the essence of this Court's ruling in *West Ohio Gas Co.* v. *Public Utilities Commission*, 294 U.S. 79 (1935), that due process demands that judgment be based on facts rather than hypotheses or fictions, at least where, as here, the facts were before the decision maker at the time of the decision. *West Ohio* was violated by the decision below in two ways: first, with regard to a question that was on all fours with *West Ohio*, and second, by a ruling that is plainly inconsistent with its rationale.

A. The Violation of *West Ohio*.

In *West Ohio*, this Court held it to be a violation of due process for a regulatory agency to rely on previous

estimates in setting rates and ordering refunds when actual financial results demonstrated that the actual earnings were below the return the agency had found reasonable. The Court held that the refusal of the Ohio Commission to be guided by the actual results before it was an "arbitrary restriction in contravention of the Fourteenth Amendment and of 'the rudiments of fair play.'" 294 U.S. at 81. Mr. Justice Cardozo, for a unanimous Court, reasoned:

> The earnings of the later years were exhibited in the record and told their own tale as to the possibilities of profit. To shut one's eyes to them altogether, to exclude them from the reckoning, is as much arbitrary action as to build a schedule upon guesswork with evidence available. There are times, to be sure, when resort to prophecy becomes inevitable in default of methods more precise. At such times 'an honest and intelligent forecast of probable future values made upon a view of all the relevant circumstances' [citations omitted], is the only organon at hand, and hence the only one to be employed in order to make the hearing fair. But prophecy, however, honest, is generally a poor substitute for experience. * * * We have said of an attempt by a utility to give prophecy the first place and experience the second that 'elaborate calculations which are at war with realities are of no avail' [citations omitted]. We say the same of a like attempt by officers of government prescribing rates to be effective in years when experience has spoken. A forecast gives us one rate. A survey gives another. To prefer the forecast to the survey is an arbitrary judgment. [294 U.S. at 81-82.]

The constitutional principle established in ***West Ohio***

has been regularly followed in most state and federal courts.[36]

In 1974 the Commission set the reasonable rate of return for Petitioner at 8.85% per year[37] and established new rates. In 1976 the Commission granted another rate increase, because Petitioner had not achieved that return under the 1974 rates. By the time the Commission decided this special tax proceeding, the actual experience under those rates was known, was before the Commission, and was not disputed.[38] Pacific earned only 7.57% in 1974, 7.6% in 1975 and 8.1% in 1976.[39] The shortfall in earnings actually ex-

---

[36] *E.g., Williams* v. *Washington Metropolitan Area Transit Comm'n*, 415 F.2d 922, 945-46 (D.C. Cir. 1968), *cert. denied sub nom. D.C. Transit Sys., Inc.* v. *Williams*, 393 U.S. 1081 (1969); *Intermountain Gas Co.* v. *Idaho Pub. Utils. Comm'n*, 98 Idaho 718, 722, 571 P.2d 1119, 1123 (1977); *New York Tel. Co.* v. *Public Serv. Comm'n*, 29 N.Y.2d 164, 169-170, 272 N.E.2d 554, 556 (1971); *General Tel. Co.* v. *Michigan Pub. Serv. Comm'n*, 341 Mich. 620, 67 N.W.2d 882 (1954). *But see South Central Bell Tel. Co.* v. *Louisiana Pub. Serv. Comm'n*, 355 So. 2d 253 (La. Sup. Ct.), *cert. denied*, —— U.S. ——, 98 S.Ct. 3103, 57 L.Ed.2d 1142 (1978) (White, J., and Powell, J., dissenting); *Mountain States Tel. & Tel. Co.* v. *Public Utils. Comm'n*, 180 Colo. 74, 81, 502 P.2d 945, 948 (1972).

[37] This was reduced on November 2, 1976 to 8.843%. Cal. P.U.C. Decision No. 86593.

[38] Ex. 9, p. 8; Ex. 10, Part 1. The failure of the existing rates to permit earning the authorized rate of return was again brought to the Commission's attention in Pacific's motion for rehearing (Ex. B to App. for Reh.).

[39] The rate of return figures cited are based upon the Commission's required ratemaking adjustments. The actual financial data (also in evidence and undisputed) is far worse; by a series of "adjustments" that are not the subject of this appeal, the Commission excluded large segments of the rate base and expense. For

perienced was huge: $123 million in 1974; $126 million in 1975; and $79 million in 1976. This was the actual situation before applying the rate reductions ordered by the Commission in this case. The refunds ordered here are $19.5 million for 1974; $61.3 million for 1975; and $57.9 million for 1976. (Tables 1, 3, and 5 of the decision, App. B. pp. 56A, 60A, 64A.) Had the Commission applied its ratemaking adjustments to the actual financial data for those years, the rates could not have been reduced. In the decision below, the Commission nevertheless ignored the shortfall revealed by the actual financial results, ordered the rates set in 1974 and 1976 reduced and ordered refunds reflecting that reduction back to 1974.

We do not argue here that the insufficient rates of past years must be retroactively raised in this proceeding to eliminate the actual shortfall experienced, for California law does not guarantee earning the return authorized. But where the rates in effect actually produced earnings far below the authorized return, the State cannot, consistent with due process, force those inadequate rates even lower.

B. The Decision Has A Destructive Impact On Pacific's Financial Integrity And Thereby Violates The Fourteenth Amendment.

In addition to ignoring the realities of the past, the Commission took no account of the effect of its action

---

financial reporting the actual return figures were 7.2% for 1974, 7.35% for 1975 and 7.78% for 1976. (All figures relate to the intrastate business only.)

on Pacific's present or future financial integrity. By making rates on the assumption that Pacific is eligible for the federal tax benefits when in fact the ratemaking methods employed themselves destroy that eligibility, the Commission has simply confiscated a large portion of the earnings Pacific should receive.

The Commission's AAA method immediately denies any return on a large amount of investor-supplied capital.[40] In addition, the rate reductions and the effect of retroactive ineligibility for the tax benefits will force the actual rate of return two percentage points or more below that found reasonable by the Commission and California Court.[41]

The effect of the loss of eligibility for the tax benefits is utterly destructive of Pacific's financial integrity and will severely handicap, if not destroy, its ability to attract capital. The enormous risk has already had an adverse effect on Pacific's bond rating. The Commission itself found that the loss of eligibility would result in "the deterioration in financial position . . ." and would "create staggering financial problems . . ." (App. B, pp. 21A-22A).

---

[40] For example, in the most recent test year the AAA excluded $556 million from rate base when the reserve for the test year was only $374 million. Thus, $182 million of investor capital was denied any return, even if eligibility is assumed.

[41] For past years, recognizing the full rate base and tax expense the actual returns are reduced to about 6.94% in 1974, 6.42% in 1975 and 6.79% in 1976, well below the 8.85% the Commission held reasonable. The return on the equity portion of the capital is forced below the cost of long term debt sold during the period. Ex. 10, Tr. 928.

This action by California directly contravenes the limitations placed upon state regulatory authority by the Fourteenth Amendment. In *Federal Power Commission* v. *Hope Natural Gas Co.,* 320 U.S. 591 (1944), and *Bluefield Waterworks & Improvement Co.* v. *Public Service Commission,* 262 U.S. 679, 693 (1923), this Court held that the reasonable return safeguarded by the Fourteenth Amendment is one "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital" (320 U.S. at 603). In *Permian Basin Rate Cases,* 390 U.S. 747, 792 (1968), this Court held that an important function of review is to "determine whether the order may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable." The impact of the decision below in reducing the rates and risking a billion dollar back tax liability is to destroy investor confidence. Clearly, this regulatory action fails to meet the Constitutional standard. The Commission's own findings on the consequences of the loss of eligibility concede the confiscatory effect.

Regulatory action that is blind to such jeopardy is an abuse of state power. In *New England Tel. & Tel. Co.* v. *Public Utilities Commission,* —— Me. ——, —— A.2d —— (1978),[42] the Maine Supreme Court reversed

[42] The decision is reported in abridged form in [1974 *et seq.*] Util. L. Rep. (CCH) (State volume) ¶ 22,596.

action by the Maine Commission that had reduced rates in a manner that almost certainly would have destroyed eligibility for accelerated depreciation. The Maine Supreme Court held that merely placing the utility "in jeopardy of losing its ability to take accelerated depreciation for federal income tax purposes" was an "unreasonable exercise of power and abuse of discretion" (—— A.2d at ——, [1974 et seq.] Util. L. Rep. (CCH) (State volume) ¶ 22,596.03). Although the Maine decision was rendered under state law, its reasoning is equally applicable under the due process clause.

This Court has held that "rates are 'just and reasonable' only if consumer interests are protected and if the financial health of the [utility] in our economic system remains strong." *Federal Power Commission* v. *Memphis Light, Gas & Water Div.,* 411 U.S. 458, 474 (1973). If left standing, the decision below is destructive of both interests.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that certiorari should be granted.

ROBERT V. R. DALENBERG
MARGARET deB. BROWN
140 New Montgomery St.
San Francisco, Cal. 94105
(415) 542-1507

Attorneys for The Pacific Telephone and Telegraph Company

Of Counsel:

MORTIMER M. CAPLIN
1101 Seventeenth St., N.W.
Washington, D.C. 20036
(202) 862-5050

FRANK ROTHMAN
GARY N. JACOBS
2049 Century Park East
Los Angeles, Cal. 90067
(213) 556-8000

October 1978